Technical Notes
NATIONAL SOCIETY FOR BUSINESS BUDGETING •
Alvin H. Weiss, Editor • 4400 W. National Ave. • Milwaukee 14, Wisconsin

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Fellow Budgeteers: Thank you for the generous response to our first issue of Technical Notes. As you know, "Technical Notes" is an official bulletin of the National Society for Business Budgeting and is a product of the membership of that organization.

The N.S.B.B. has no paid officials, therefore, anything done by this organization must be through the voluntary efforts of its membership who are interested in the advancement and improvement of budgeting.

It would not have been possible to produce "Technical Notes" without the assistance of many members of the Society. Space does not permit acknowledgment of the help given by many individuals, but nevertheless I want to express my appreciation to all those who have made a contribution to the publication of Technical Notes.

The continued success of this publication is dependent upon the participation of the entire membership in this project.

Here are some specific ways in which each member may make a contribution to "Technical Notes":

1 - The preparation of original material on budgetary subjects.
2 - Send copies of good talks given on budgetary subjects.
3 - Submit your questions to the "Question Box."
4 - Send in ideas and suggestions for the improvement of technical notes.

Last month we received many good comments on Dr. Bliss' article on suggested reading matter for the busy businessman, which was reprinted from the Harvard Business Review. Of interest to budget people in an article in the April 1952 issue of Fortune Magazine entitled "P & C for Profit" by Perrin Stryker, in which this question is asked, "Is your company earning as much as it could? or has it unknowingly sacrificed profits for volume, false efficiency, prestige, or some other pet policy? Here is a report on the recent conversion of many top managements to "planning and control" - P & C."

The following is a reprint of the introduction to this interesting article:

"The belief that the top managements of large corporations have a single-minded devotion to profits is one of the great myths of modern American capitalism. As almost any management consultant can tell you, a company's top executives are likely to put a lot of things ahead of profits, and what's more, the pursuit of these other objectives may seriously impair the company's earning power. Keith Powlison, Armstrong Cork's controller, documented this amusingly in an article in the Harvard Business Review, in which he described three distinct categories of management's non-profit motives: "Empire Building," "Ivory Tower Perfectionism," and "Maginot Line Building."

Empire builders may want to be the biggest in the field, to keep chalking up one all-time sales record after another; or they may want to be the first to hit the market with a new product, or yearn to blanket the market with an awesome line -- everything "from a pin to a battleship," as the copywriters might put it. The perfectionists have their eyes fixed on the goal of efficiency, expressed in such standpat edicts as "Keep those credit losses to a minimum" (even though more generous credit terms might raise profits), and "Scrap allowances will be held to 5 per cent" (though this might easily raise production costs). The Maginot Line builders, in turn, pass up profits through fear of taking risks, insisting, for example, on too little plant, too much cash, and so forth.

Among such managements are those who cherish and promote an outmoded product sheerly out of sentiment, perhaps because the founder -- who is now retired as chairman of the board -- still regards it as "the cornerstone of the business." Or because the product still pleases a few old customers whose trade was once the company's sole support. Another management may push some new product or service merely for the glamour it is expected to bestow on the corporate name, and be perfectly willing to charge the venture to "good will."

There are also those managements who indulge in "business statesmanship." Some may dedicate themselves to union negotiations and to advancing industrial relations generally. Others concentrate on improving the community. And finally there are those who apparently manage mostly for the sheer fun they get out of their jobs. Many of these management motives are justified, and indeed admirable. But they do raise the question of management's first responsibility, profits. Keeping an eye on profits may well become the prime problem of top management, particularly in very large companies.

BUDGETING - A MANAGEMENT CONCEPT

By C. E. Jarchow, Vice President and Comptroller
International Harvester Company

The functions of business enterprise generally include the following: producing goods, providing services, making employment available, serving community needs, paying dividends, etc., but there is one basic principle which is inherent in all business enterprise. It must remain alive and vigorous, it must replenish itself, and it must grow. Theoretically, it may seem possible for a business enterprise to stand still, but in actual practice business seldom survives if it does not grow.

Business may succeed in attaining growth solely through fortunate economic circumstances, but more often it is the result of business management. Good management is dependent upon sound business planning, that is, looking ahead and planning not only for the immediate future, but for an extended period beyond. To do such planning intelligently, it is necessary to give expression to its probable effects in figures. This inevitably involves the forecasting or budgeting technique whether it is expressed in a formal budget system or not. The foresight and judgment used in such planning and forecasting have an important bearing on the ultimate success of programs which may result therefrom. In developing such forecasts historic data is of value in the light it throws upon the future. It is important for management to know the past accomplishments of the Company and in a sense to know where the Company has been, but it is much more important to know where the Company is going, the direction of its course, and the influence of important trends. There are three basic ideas inherent in the budgeting concept as it applies to business forecasting: (1st) looking ahead, (2nd) establishing a goal or target toward which efforts can be directed, and (3rd) limiting commitments and making such changes in policy as may be necessary to attain that goal.

The International Harvester Company does not maintain a centralized budget department and yet we carry on a great deal of budget work. This budget work is decentralized by divisions and by staff departments. Despite this decentralization, there is a great deal of coordination of effort through the Operations Review Committee to which I shall refer later. We believe our decentralization has some definite advantages since the objectives are broken down into smaller segments and more individuals are therefore directly concerned with the attainment of desired goals. In 1945 the Company adopted a divisional form of organization and today we have 9 divisions or operating units, which handle the business in the United States. Each of these divisions has a considerable degree of autonomy in its operations. Each of our operating divisions has a certain amount of net assets to work with and is expected to make a definite contribution, with those assets, to the profits of the Company. These goals and accomplishments are reviewed by our Operations Review Committee which is headed by an Executive Vice President and includes in its membership several staff Vice-Presidents, the Treasurer and the Comptroller. This Committee holds periodical meetings with the several divisions, at which an important subject of discussion is the financial results of operations - past or current - and the relation of these results to the profit objective. These discussions also involve looking ahead at the factors which affect the demand and price of the division's products; the current costs of products and future trends; competitive factors; the proposed changes in productive facilities, development of new products; etc. The division management, in preparing for the meeting, reviews all of these matters with its staff and attempts to foresee their future course. Policies are re-examined, and recommendations, whether made by the divisional management or by members of the Committee, receive thorough discussion. As a result of all this, decisions are made which will assist the division in reaching the profit objective. This objective is thus a real budgetary goal for the division. Proposed new products, or proposed new facilities, which will not contribute their share to the profit objective may be turned down. Also products which are yielding little or no profit because of obsolescence, decline of market or other reasons may be discontinued as not contributing properly to the profit goal.

Within each divisional organization budgetary procedures extend through the various operations. These budget procedures are related to the divisional profit objective and are analyzed so that the various sales offices, plants, and departments within the plant are aware of the goals they must attain in order to reach the total objective. The work of setting intermediate and primary targets directly related to the final goal sometimes reveals situations where additional equipment must be secured or policies changed in order to make such targets attainable for the departments concerned. This profit objective approach in effect places all managerial people in the division (from shop foremen on up) in the position of being in business for themselves. It furnishes them with a guide as to the maximum costs and expenses permissible if they are to run that business on a satisfactory basis. If everyone attains his goal, the over-all objective for the division will be met. If the over-all results are not realized, it can easily be ascertained where the failures have occured and what should be done to overcome them.

First I would like to speak of the establishment of sales estimates and quotas. For a Company such as ours, the determination of quantities of goods to be produced is a most vital part of business management. It is so important in fact that we have a separate staff department - called Estimate and Order Review - which provides the management with the data needed to make the necessary decisions. This department receives estimates from the sales territories which in effect represent the critical judgment of our district managers as to the quantities of goods our dealers want for the coming season. Territorial estimates are checked and rechecked against

the opinion of sales executives in the General Office, or against forecasted general economic conditions, including the trend of industrial production and farm income indices, etc., and also against our capacity to produce. Out of all this looking ahead comes a balancing of the prospective supply and demand for Harvester products. This might be called a budgeting of goods. Such budgeting might result in limiting production to levels well below plant capacities, on account of inability of the market to absorb our full production; or it might result in limiting our promises to dealers if it is evident we cannot supply their full requirements.

In connection with this budgeting of goods, there is a further follow-up through the year as sales demand develops. Since our scheduling of production has been in terms of detailed types and sizes of machines, it is necessary for us to watch the actual orders very closely and adjust our production schedules during the year. Furthermore, there may be either an unusually good or an unusually bad crop condition in certain parts of the country which sometimes makes a marked difference in the number and kinds of machines required. Consequently our sales budget is quite flexible and is adjusted frequently to actual requirements.

I should next like to speak of the inventory budget. We in the Harvester Company, in common with most businesses, are feeling very keenly the drain on working capital caused by the increased prices of materials needed for production. We have felt it desirable to work our inventory budgets for our plants, with due allowance for seasonal factors, and to use them as targets for inventory control. The proper working out of an inventory budget is, of course, complicated with many factors to be considered. It must take into consideration such factors as lead time and keeping the inventories in line with the critical items in short supply. There is a natural inclination among manufacturing men to want ample inventories at all times, so as to be certain that production will not be delayed for lack of materials. This, however, may be very expensive and may require excessive amounts of working capital. On the other hand, we must guard against over zealous actions which may result in undue penalties on profits. This can occur by buying in uneconomically small lots or by permitting inventories to sink to abnormally low levels. I will not say that our inventory budget plan has been perfect, but it has been quite successful in the important job of conserving working capital.

The budgeting concept is quite generally used in connection with such things as a company's productive equipment policy. Some companies operate on the basis of a new piece of equipment "paying off" in a certain number of years. Others work on the basis of new equipment earning a certain percentage on investment. In either case, it involves a forecast of the probable use of the new equipment and an estimate of the savings in cost which it will contribute. It is these prospective savings which determine whether the new machine can be afforded or not. Many business decisions which must be made involve this sort of thinking. It applies when there is a question of whether to replace a piece of equipment with a newer and more efficient tool. It also applies when there is a question of whether to change the design of a product or to get out new models. It also applies when there is a question of whether a company should go into the manufacture of some component which has previously been purchased, or vice versa. For in all these cases, we are in effect forecasting (or budgeting) the operating savings which will accrue, or the increased income which will be received if the plan is followed out, and limiting our favorable decisions to those which we can best afford.

In the Harvester Company all expenditures for capital purposes are made on the authority of regular appropriations. These are approved by the Board of Directors when large amounts are involved, or by certain officers of the Company to whom the Board has delegated appropriation authority. Appropriations for purposes which I have just described are approved on the

basis of estimated savings to be derived when the new equipment is in operation. Our system calls for a report to be rendered by the operating unit which has installed such equipment setting forth the actual savings as compared with the original estimate. This report is made only after the new equipment has had a fair period of operation. It is in a sense a budget report because it compares actual accomplishment with the target of estimated savings which was set when the appropriation request was approved. Once each year a summary of all appropriation savings reports which have been issued during the previous twelve months is presented to the Board of Directors.

I might say a few words about the cash budget. This is used by our Treasurer to forecast the cash position at various interim dates and thereby assist in determining seasonal borrowing requirements. This is very important in a Company subject to seasonal influences. It is somewhat different from the budgets I have previously mentioned, however, for it portrays in the main the end result of all the other planning which I have been describing. Obviously if very unfavorable circumstances are present and if borrowing sources are not readily available, the cash budget could demonstrate the necessity of restricting operations to the point where they would be within the limits of available resources.

We have also developed a form of budgeting in the Harvester Company in connection with long-range financial planning. This is based upon the establishment of a budget for capital expenditures for the current year and the succeeding four years. This budget is reviewed quarterly with the executive management and revisions are made whenever necessary. In conjunction with this quarterly capital budget, forecasts of the operating results and financial position of the Company are prepared, generally to the end of the succeeding fiscal year. These forecasts and capital budgets form the basis for quarterly discussions by an officers' finance committee. These quarterly finance meetings are usually held just prior to the regular meeting of the Board of Directors. At the Board meeting these long-range reports are presented for consideration, together with such recommendations as the committee may wish to make. These budget reports are most useful to the management and to the Board, although I do not want to leave the impression that we can accurately predict our capital requirements for a five-year period or even our current financial position to the end of the next fiscal year. However, since these budgets are revised each quarter, there is a periodical correction of any inaccuracies.

And now to conclude. The above examples of the use of the budgetary concept in business planning will serve, I hope, to indicate its importance. It impinges upon many business decisions since most of these require forward planning and forecasts of their financial effects. The budgetary concept forces business executives to an early study of their problems. It compels them to make a decision this month which will govern next month's operations instead of waiting until the circumstances which require a decision are upon them. It provides a vehicle for re-examining operating policies periodically. This manner of thinking also encourages the habit of careful study of proposals and recommendations before they are presented to top management for approval. It sets targets, and defines objectives. It provides gauges of performance which can be kept in mind by those responsible for results so that they themselves may know whether they are doing a satisfactory job. Having set definite goals before an organization, it is much easier to enlist that genuine cooperation which is so necessary for effective performance. And when the entire organization is committed to the attainment of definite and recognized results a high degree of cooperation can be secured.

CASH BUDGETS AND METHODS OF PREPARATION

By E. W. Buge, Controller
Bernardin Bottle Cap Company, Inc.

The general cash budget is utilized primarily as a guide to major financial policies and as a routine working tool for the financial executive. Major financial policies, usually established by the management group are generally concerned with the raising of additional capital or the utilization of funds already available. These activities cover plant expansion, the development of new products, the flotation of additional securities, the liquidation of existing long and short term debt and the determination of dividend policies. Routine financial operations include the meeting of payrolls, discounting invoices, and the daily adjustment of financial activity to the cash balances.

Specialized methods of utilizing the cash budget for various financial purposes are summarized below:

1. Reduction of long term debt.
2. Financing peaks in business activity for seasonal businesses.
3. Provision for maturing short term debt.
4. Provision of funds for Federal Income Tax payments.
5. Acquisition of other companies.
6. Long range plant and equipment expansion of replacement.

The near term estimates are used as a guide to current cash requirements. Most concerns utilize a budget having a period of one year or less. These forecasts are periodically revised on a quarterly or monthly basis. The most common reason advanced for the use of a short budget period is the difficulty of preparing accurate forecasts over a longer period. Cash requirements can vary rather rapidly particularly in a seasonal business.

Long term cash budgets of over one year are used by approximately one-half of the companies doing cash budgeting. Practically all concerns preparing a complete operating budget utilize the data developed therein to prepare an annual cash budget. The most effective use of long term cash forecasting is in plant expansion programs, the retirement of long term debts, and a general three to five year cash requirement forecast for determining the approximate cash needs of a business during the period.

Probably the easiest and most reliable way to forecast cash requirements is the receipts and disbursements method. It is estimated that approximately 75% of the companies doing cash forecasting rely on this method. Although the terminology may vary the general types of information utilized in building up the budget are as follows:

1. CASH RECEIPTS
    - a. Collection on accounts receivable
    - b. Cash sales
    - c. Short term borrowings
    - d. Sale of plant or equipment
    - e. Sale of materials or supplies
    - f. Other income such as, rents, interest, scrap sales, etc.
    - g. Sale of securities or long term obligations.
2. CASH DISBURSEMENTS
    - a. Materials and supplies or payments on accounts payable
    - b. Payrolls
    - c. Other operating expenses
    - d. Advertising expenditures
    - e. Construction or plant and equipment expenditures Particularly important when a large expansion program is under way.
    - f. Federal and State Income Taxes
    - g. Dividends and interest
    - h. Retirement of long term debt
    - i. Retirement of securities

The manner in which these items are classified for cash forecast purposes varies with the type of business and the complexity of its operations.

A second method of forecasting cash requirements is the Profit and Loss type which is generally used by companies that have fairly stable operations and stable volume. It requires the forecast of the expected net income over the forecast period and then adjusting this figure to a cash basis by means of various additions and deductions.

The general method of preparing a cash forecast by this method is as follows:

1. Estimated Net Income
2. Additions to Net Income
   a. Non cash items chargeable against income (depreciation, accruals, taxes, insurance and interest.)
   b. Net decreases in working capital (receivables, inventories and payables.)
   c. Short term borrowings
   d. Sale of securities or long term obligations
   e. Sale of plant and equipment
3. Deductions from Net Income
   a. Cash payments on accruals, taxes, prepayments and deferred items
   b. Net increase in working capital (accounts receivable, inventories, payables.
   c. Capital expenditures
   d. Redemption of company securities
   e. Repayment of short or long term obligations
   f. Payment of dividends

A third method involves the application of a series of adjustments to the net working capital available at the beginning of the budget period, in order to compute the working capital available at the end of the period. From this figure we subtract the estimated working capital (exclusive of cash) the difference being the estimated available cash.

This forecast method is the most complex and least used of the three types of forecasting procedures. It involves a comprehensive statistical procedure and has been found to be very reliable. It is mentioned merely as a matter of record and not as recommended procedure for the average controller.

All forecasting is subject to the human error involved. This is not a reflection on the individual preparing the forecast but rather a warning as to the various pressures which affect the clear and reasonable thinking by the forecaster.

1. Do not overestimate. A cash budget is one place where a considerable amount of conservatism can be applied with sound results.
2. Study your statistical data carefully. Unusual cash receipts or disbursements can be found by studying past records. These items can seriously affect your results.
3. Watch your "lag period" in the collection of your accounts receivable. Collections vary with the month of the year and with general economic conditions. Seasonal businesses must be particularly careful in this respect.
4. Keep your ear to the ground regarding executive action on large expenditures. Often they have a way of sneaking up on the forecaster without warning.
5. Don't overlook good common "horse sense." A hunch will often get you just as far in the forecasting game as a very complex statistical approach to the problem.

COORDINATION OF SALES AND PRODUCTION PLANNING

By Arthur P. Meier, Supervision of Budgets
American Hard Rubber Company

At American Hard Rubber Company, each salesman estimates the demand for his products in his sales territory for the budget period, and submits these estimates to the Budgeteer for summarization, etc. These estimates are then tested and reviewed by the Sales Manager and the Budgeteer together with the Salesman to arrive at an acceptable Sales Plan for each territory. The territory Sales Plans are then combined into summarized sales estimates for each Sales Division and considered in the light of available productive capacity and other Company facilities. Following this consideration and the application of other appropriate tests, Division Sales Plans are then established by the Division Sales Manager, the Vice President - Sales, and the Budgeteer.

After setting these preliminary Sales Plans for each of the Sales Divisions, it is the Budgeteer's responsibility to summarize these Plans into a Company Plan, in terms of Product Sales Classes and Plants. The Budgeteer discusses the Company Plan with the Vice President - Sales, pointing out the major changes in future sales as compared with past performance, as well as a comparison of sales volume with available plant capacity. When the Vice President - Sales approves the Company Plan, it is summarized into major groups and classification for review and approval by the Company President. When the summarized Company Plan is sent to the President, the Budgeteer includes an explanatory letter which highlights the changes in future sales volume for each Key Product Line of each Sales Division for the budget period ahead.

After discussion of the Company Plan by the President, Vice President - Sales, and the Budgeteer, with adequate substantiation that the plan can be produced as well as sold, and with the resolution of all questions, the approval by the President establishes the Preliminary Sales Plan for the Company.

The next step then is to convert this Preliminary Company Sales Plan into a Profit and Loss Forecast, after which the President reviews it for final approval. When finally approved, it becomes the Company Sales Objective or Budget for the ensuing year and all sections of this Budget pertaining to the direction of Sales effort and Production Planning are released from a static position to active use as soon as possible.

When the Sales Objective or Budget is sent to Production, all pertinent information on quantities, style, order dates, delivery dates, etc., should be included in order that Production have in its possession complete information with which to prepare detailed production schedules. On the basis of the resulting departmental and plant production schedules, Production then is able to advise Management and Sales of the status of plant capacity, inventory positions, etc., with which Management is then prepared to determine what further steps, if any, need to be taken to maximize Company profitability.

The same high degree of coordination and interchange of information that existed at the time of preparation of the annual budget must be maintained during the entire budget year. Sales must have available to it accurate, prompt, and frequent reports with which to compare actual to budgeted sales, in terms of quantity, prices, and time. This comparison will point out those areas in which actual sales volume is deviating from the forecast upon which the production program has been established. In addition to this internal comparison, Sales must continually monitor those conditions affecting sales volume such as changes in consumer demand, changes in consumer preference, changes in trade and general economic conditions, etc. All data on changes in the sales outlook should be transmitted frequently - immediately where changes are substantial - to Production so that revisions can be incorporated as soon as possible into the production schedule.

Production must also maintain a constant watch, through prompt, frequent, and accurate reports, of the inventory positions on all of its major lines in order that Sales can take whatever action is necessary to revise its sales plans to reflect changes in inventory. Where Sales maintains control of inventories, such as territory warehouses, etc., it is Sales responsibility to maintain a close watch over actual inventories so that unanticipated changes in sales can be reflected in immediate revisions to the Production program.

Production must also maintain its own system of check points with which to determine or measure the degree of actual plant utilization as compared with forecast, and to reflect the effect upon plant capacity of current revisions in the several sales forecasts. It is the responsibility of Production to advise Management of actual plant capacity and to work with Sales in maintaining the most economical work-load at all of the Company's facilities.

Only through a high degree of sales-production cooperation and coordination can the business organization expect to maintain the highest level of profitable operations. This can best be obtained by establishing and maintaining a definite procedure, possessing the appropriate degree of flexibility commensurate with the individuals involved, for the prompt, accurate and complete interchange of information pertaining to the trend and status of sales and production volume.

QUESTION BOX

The "Question Box Committee" of Technical Notes is waiting for more questions after their first attempt in answering the rather tough one presented in the December issue.

How about it, fellows?

I suppose the holidays have temporarily taken our minds off the subject of budgets, but no doubt when the January bills come rolling in there will be a renewed interest in the subject of "budgets" and we can expect a flood of questions on how to reduce expenses, cash budgets, forecasts, etc.

Your Editor first ran across something which I am sure merits comment by members of the N.S.B.B. In a section on "Administering a Budget Program" in the Corporate Treasurer's and Controller's Handbook, edited by Lillian Doris and printed by Prentice-Hall, Inc. of New York, we note the following statements relative to "Fixed Budgets" and "Flexible Budgets."

"A fixed or inflexible budget program should be the ultimate goal of every well run business organization that manufactures on a stock basis, because it enforces the need for accurate forecasting, accurate planning, and, most important over-all coordination and follow up if the budget goals are to be achieved." * * * *

"Variable or flexible budgets. This type of budget is predicated upon the variability of costs, and hence expenditures, at different levels of operation. The variable or flexible budget is used in companies where the forecasting technique has not been developed to a high degree of perfection, or where the nature of the demand for the company's products and services is especially volatile, as may be the case in a company manufacturing highly styled items or on a customer-order basis." * * * *

If any members of the N.S.B.B. have any comments on the foregoing statements "Pro" or "Con," your Editor earnestly requests that you voice them through the medium of "Technical Notes."

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